

Residential Site Leasing Rate Survey

PURPOSE

At the State Board of Land Commissioners meeting of September 12, 2006, direction was given to compile information on how other states structured their residential site leasing programs. The survey findings are provided within this document.

BACKGROUND

Idaho Department of Lands (IDL) began the Residential Site leasing program in 1932 with the first residential site lease at Payette Lake. Since that time the residential site leasing program has increased to a current total of 538 sites. There is the potential to develop additional residential sites in both the Payette and Priest Lake areas should the Land Board choose that option. In the future, 100 – 200 more sites could conservatively be brought on-line, depending upon economic conditions, as well as health and safety requirements that must be met in the form of infrastructure availability.

Currently, Idaho calculates the annual rent (lease rates) for residential sites in one of two ways: either based on the current market value, or on the current assessed value of the site. The appraised value is used for rent calculations at Priest Lake and assessed value is used at Payette Lake. Two and one-half percent (2.5%) of the value – either market, or assessed – is the amount that is charged for rent on each residential site. Additional revenue from residential sites occurs when a lease is assigned, or when transferring ownership of improvements. A lease assignment is when a lease holder sells the structure on the residential site, and the responsibility of the land lease is then assigned to the new owner of the home. A premium is collected totaling 10% of the leasehold value – the value of the sale price, minus taxable improvements such as a house, accessory structure or a dock.

The most recent review and adjustment in the residential site leasing rates was done in 1998, when the 2.5% rate was set. The only adjustment that has occurred since that time was in the leasing program at Priest Lake. Historically Bonner County assessed values were used as a basis of lease payment calculations prior to 2003. During the period between 2003 and 2006 IDL transitioned to the use of market (appraised) values for lease calculations for Priest Lake residential sites.

ANALYSIS

A survey of eleven other states or agencies was conducted to gather information on residential site leasing programs or similar activities. The table below is a brief summary of the survey results. Except for the National Association of Real Estate Investment Trusts (NAREIT) data, all revenues shown are gross and do not reflect net return on asset.

| SOURCE | COTTAGE/CABIN SITE LEASE FORMULAS |
|---|---|
| ALASKA | Remote Cabin Sites – 1 st lease term of 3 years – \$100/yr, 2 nd lease term of 5 years –\$1000/yr – then purchase site or lease expires |
| COLORADO | No current program – handful of cabin buildings that are included in recreation/multi-use leases |
| IDAHO | 2.5% of either assessed value (Payette Lake) or market (appraised) value (Priest Lake) |
| MONTANA | 5% of market value |
| OKLAHOMA | 10-10.5% return expected on a residential lease – very few residential leases – commercial/mixed use |
| OREGON | No program. |
| UTAH | Market value times current prime interest rate (07/06 = 8.25%) |
| WASHINGTON | No program |
| WYOMING | 5% of the market value |
| BUREAU OF LAND MANAGEMENT – IDAHO OFFICE | No program |
| IDAHO DEPARTMENT OF PARKS AND RECREATION | <ul style="list-style-type: none"> Multiple types of rentals – yurts, backcountry yurts, and cabins. Rate structure differs significantly from other programs – nightly rental rates vs. annual leases based on market values. Annual Gross Revenue Stream (assuming rental for 200 nights annually) – \$1,784,600 <ul style="list-style-type: none"> Yurts (169) – \$1,183,000 Backcountry Yurts (5) – \$81,600 Cabins (58) – \$454,000 Houses (2) – \$66,000 |
| TIMESHARE | Multiple ownership of a unit based on use for a specific amount of time occurring on an annual or bi-annual basis. Maintenance fees are charged for upkeep, insurance and assessments for each unit. |
| REAL ESTATE INVESTMENT TRUST (REIT) | 7-11 % NET 11.06% is the 20-year average annual rate of return – website for reference www.nareit.com |

Discussion of the survey findings:

Valuation and Rate Comparisons

- The valuation and lease rate formulas for Montana, Oklahoma, Utah and Wyoming are based on market (appraised) values in all cases. The percentage of market value used to calculate the annual lease amount varies.
 - ✓ Montana and Wyoming both use 5% of market value for the annual lease rate.
 - ✓ Utah's lease rates are determined by the market value times the current prime interest rate.
 - ✓ Oklahoma's program is least like any of the other states surveyed. The most similar program that Oklahoma has is actually a commercial/mixed use lease. One example found is a mixed-use lease that includes two resorts with cabin rentals as part of the resort operation, commercial areas and future sites for single-family residential lot sales. The expected gross revenue on the commercial residential rental portion of the lease is between ten to 10-10.5% annually. Again, all values and rates are based on market value of the development.
- Alaska has a unique program for Remote Cabin Site Leasing. This program is similar to "homesteading" for an annual fee than benefiting a residential site leasing program. The ultimate goal of Alaska's program is to sell the Remote Cabin Sites after either the first or second lease term. The intent of this program is not to create a long-term revenue stream from an individual site.
- Idaho Parks and Recreation Department has an extensive system of nightly rentals using yurts, backcountry yurts, cabins and ranch houses. Again, this system is based on nightly rentals and not based on a percentage of either assessed or appraised value of the sites. Another major difference in this program is that the cabins and yurts are not constructed or owned by the renter. The structures are owned by the Parks and Recreation Department.
- Timeshare programs were also reviewed as part of this survey. Timeshare property is held in multiple ownership per unit based on an amount of time used annually, or bi-annually. Timeshare is a type of ownership and not a lease situation. Generally, the expected return on investment is a minimum of 10%, which is similar to the type of commercial return described in the Oklahoma example.

Length of Leases

- Lease terms vary by state:
 - ✓ Idaho issues 10-year residential leases.
 - ✓ Utah generally is issuing residential leases for between 20-30-years.
 - ✓ Wyoming has a maximum lease term of 25-years.
 - ✓ Montana uses a 15-year lease term.

Review Cycles

- Land appraisals occur in Utah every 3 years
- Montana uses a 5-year review cycle for updating land values through appraisals.

Miscellaneous Findings

- Idaho is the only state that collects a premium when leasehold interests are sold. While conducting the survey, several states were very interested in this concept.
- Alaska's program, although quite different in its long-term goal, does include a minimum lot size of 5 acres and a maximum lot size 20 for its remote leasing program. This is the only state found in the survey that addressed lot size requirements.

- Of the state/agencies surveyed none of them addressed geographic location (shoreline verses inland locations), lot access restrictions (ex. lake only access to a residential site), or infrastructure as a basis for using a tiered lease rate system. When market (appraised) value is used as the sole basis for lease rate calculations these variables are considered in the appraisal process. The resulting valuation is reflective of the location, access and condition of infrastructure available to any given cabin/residential site.
- No other state/agency or private business venture has a lease rate structure based on county assessed values.

RECOMMENDATIONS

Research indicates that Idaho is considerably behind other state/agency programs and similar businesses in the generation of revenue from the leasing of residential sites. A well-defined lease rate formula capable of taking into account economic fluctuations, periodic review cycles, a robust appraisal process and the use of mid-range length contracts would greatly enhance the ability of the Land Board to both stabilize and maximize returns for beneficiary institutions.

From a business perspective, IDL recommends the following residential lease structure:

- 1. The lease formula shall be based on the market (appraised) value of the residential site (land only) times a lease multiplier (percentage rate set by the Land Board) to determine the annual lease payment.**

Appraised Value x Lease Multiplier = Annual Lease Payment Amount

Justification:

- *Using the market (appraised) value of residential sites as well as updating the lease multiplier will result in an increase in the long-term revenue stream to the endowment beneficiaries. Using appraised value for all residential site leasing activities will more accurately reflect the actual value of the land asset. County assessor valuations historically lag at least 20% behind the appraised values for comparable lands.*
- 2. The lease multiplier shall be correlated to the prevailing IDL Transaction Rate, which is benchmarked to the 30-year mortgage rate.**

Justification:

This lease multiplier is recommended for a number of reasons:

- *The lease multiplier is a reflection of money markets pertaining to real estate.*
- *Real estate is the market for this asset classification.*
- *The IDL Transaction Rate is currently 6%. The Transaction Rate is based on the average monthly rate for conventional mortgages as quoted in the federal review statistical release. The rate is rounded to the nearest one-quarter percent on the tenth of the month following the statistical releases.*
- *The long term rate of return for equity holdings in Real Estate Investment Trust's (REIT) average 11.06%. These returns represent both cash revenue net expenses and value appreciation. Endowment lands serve as a REIT for the Endowment Fund Investment Board.*
- *Land values have appreciated at an average rate of 10% over the last 10 years in both the Priest Lake and Payette Lake areas.*

- The Endowment Fund Investment Board's (EFIB) annual net return is 7.25%. Endowment land returns should compete favorably with the options afforded through EFIB.
- The lease multiplier chosen is comparable to the financing (interest) rate paid for a home mortgage. As of January 16, 2007, mortgage rates available in the marketplace include: 30-year fixed – 5.990%, 15-year fixed – 5.850%, and Adjustable Rate Mortgages range from 6.210 – 7.120%.

3. Appraisals will be performed in 5-year cycles. The appraisal process will reflect such variables as geography, access, and infrastructure availability.

Justification:

Periodic appraisal cycles provide updated land value trends to ensure that lease payments remain competitive with other investment opportunities.

4. Annual lease payments will remain fixed for a 5-year period.

Justification:

Fixing the annual lease payments for a 5-year cycle reflect the appraisal cycle in recommendation #3. Reviewing and adjusting the lease rate every 5 years ensures that returns remain fairly close to market values and increases in annual lease payments will be less dramatic than the 10-year cycle currently in place.

5. Annual indexing will no longer continue as of 2010.

Justification:

Annual indexing will no longer be needed with the recommended 5-year appraisal cycle as noted in recommendation #3.

6. Modify Idaho Code to allow residential site leases for up to 30 years.

Justification:

This duration coincides with the conventional mortgage period and eases financing ability for a leaseholder.

7. Lease payment adjustments to occur every 5 years.

Justification:

Adjustments every 5 years will coincide with changes in the appraised values of the land and will be reflected on a timely basis.

8. Collection of premium rent on assignment/sale should continue.

Justification:

This premium is necessary to cover the administrative cost associated with processing the transaction and to capture intermediate value between appraisal cycles.

9. Premiums collected should represent 100% of the increased land value. Instruct the Department to amend Administrative Rules governing residential site leases (IDAPA 20.03.13) to allow for the capture of 100% premium rent collection when leases are assigned or transferred.

Justification:

- *The endowments own the land and it is reasonable to expect 100% capture of the increase in land value.*
- *100% capture of the premium rent at the time of assignment or transfer will be less onerous than it is now since the appraised value of the land will be updated every five years. Value gaps would be reduced.*

The recommendations outline a significant change in the business practices associated with residential site leasing. The implications of not changing the residential site leasing program include the following lost opportunities for the endowed beneficiaries:

- In 2005, the residential leasing program earned approximately \$4 Million with the following constraints – a 2.5% lease multiplier, two different methods of determining land value – appraisals at Priest Lake and county assessor values at Payette Lake, and a 10% premium capture limit on lessee ownership transfers. The residential site leasing program potential with the suggested recommendations includes:
 - More than doubling of the overall revenue by adjusting the lease multiplier to the prevailing real estate market rates (6%) = \$9.6 million annual recurring revenue or an additional \$5.6 million.
 - Appraising the Payette Lake sites at market value is anticipated to capture an additional 20+% of value, which in turn increases annual revenue potential by the same margin = an additional \$1.6 Million or more.
 - Increasing the premium capture from 10% to 100% could result in a 10-fold increase in transfer revenue. In 2006, one premium was collected totaling \$29,548, which translates to another \$265,932 in revenue under the 100% capture method.
 - Gross revenue in FY 2006 would have been \$11.5 million or a return on asset of approximately 7.1% without value appreciation.

Conservatively speaking, the proposed recommendations could generate an additional \$6-7+ million of revenue annually for the beneficiaries.

There are potential impacts as well to changing the residential site leasing program:

- It is anticipated that there may be a “rush” of lease assignments/sales prior to the effective date of any new lease terms.
- Payette Lake residential sites would have to be appraised to transition this area from assessed valuation to the appraised value.
- Updating all lease payments every 5 years with new appraisal data and new lease multiplier information will create a spike in workload. Any effective phase-in process to allow an even distribution of activity every year is yet to be identified. This will complicate the lease renewal and conversion process and increase management costs in the short-term i.e. more frequent appraisals during years 2010 through 2014.

Attachments:

1. Standard State Land Board of Commissioners Consent Agenda Item – IDL Transaction Rate
2. Ten-year History of IDL Transaction Rate
3. Real Estate Investment Trust Residential Return History
4. Land Value Appreciation at Priest and Payette Lakes